Warning: Declaration of c2c_AuthorImages::get_options() should be compatible with C2C_Plugin_034::get_options($with_current_values = true) in **/nas/content/live/wirerussell/wp-content/plugins/author-images/author-images.php** on line **56**

Warning: preg_replace(): The /e modifier is no longer supported, use preg_replace_callback instead in **/nas/content/live/wirerussell/wp-content/themes/inove/functions.php(8) : runtime-created function** on line **1**

Top five investment themes to watch for 2019

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How might 2019 shape up across the investment landscape? Here's our countdown for the top five key issues to pay attention to.

Move over 2018

2018 was action packed and volatile with global equity markets, geopolitics and populism dominating the year. The result was that almost all asset classes, with the exceptions of cash and government bonds, posted negative returns.[1] A lot of the same themes seem likely to play out in 2019. A significant difference, however, is that the year has begun with widespread investor pessimism, in contrast to the prevailing optimism at the beginning of 2018. From a contrarian perspective, I'm always more comfortable when markets start the year with a bearish bias.

Here is my countdown of the top 5 investment strategy themes for 2019.

2018: Top 5 countdown

5) Brexit will probably be ok.

We're in the messy final stages of the Brexit process. It looks to be going to the wire, with a range of possible outcomes. These are: a negotiated agreement, a further delay, an election, another referendum or a no-deal exit. It's tough to pick which it will be, but a soft-Brexit deal looks the likeliest. This outcome could see sterling rise in its fair value against the U.S. dollar, which we think is around 1.40.[2] This is not great news for the FTSE100, which depends a lot on overseas earnings, as a rising pound will keep it under pressure. But UK shares do not look expensive.

The economy isn't about to take off, but we think the Bank of England will probably manage one or two rate hikes if Brexit is indeed okay. 10-year gilt yields have bottomed, but like long-term government yields, we don't think they are going to rise a lot. Our model puts fair value for gilts at 2.2% — and this is probably about where yields will rise towards.[3]

4) Italy is very scary.

Italy has the potential to go very wrong. According to the International Monetary Fund, Italian government debt is roughly 130% of GDP and the economy hasn't grown in the last decade; in fact, it is still 5% smaller than 10 years ago.[4] In addition, the banks have a lot of bad debts and the government is a very unstable coalition of the right-wing populist Northern League and the left-wing populist Five Star movement. To compound matters, Italy has the world's fourth largest bond market.[5] It's literally too large to fail and too big to save. In other words, it's in an entirely different league than Greece.

Italian banks own around 20% of the government bonds on issue,[6] which means that the value of their assets go down as Italian bond yields go up. Italian 10-year yields are currently around 2.9%.[7] We believe that Italy's banks could potentially become insolvent if the yield rises above 4%[8] — they reached 3.6% in late November at the peak of the budget worries.[9] The worst-case scenario is the doom-loop, where rising bond yields cause investors to worry that the Italian government will have to bail out the banks, which causes bond yields to rise further.

That's possible, but in our opinion, unlikely. We think Italy will play out a bit like Greece in 2015 — when the firebrand populist Syriza government was forced to change its policies once it realised what crashing out of the eurozone would mean for its economy. The Italian government has already watered down its 2019 budget deficit plans after bond yields spiked in November

The Italian government can ignore the European commission, but it won't be able to ignore the bond market. That should prevent a full-blown crisis, but Italy has the potential to provide plenty of excitement over 2019.

3) China is very, very, scary.

Many people have been predicting a Chinese economic crash for a long time. We know the economy is unbalanced. It depends a lot on investment spending and doesn't have enough consumer spending. It's an over-simplification, but China's basic growth model for the past couple of decades has been state-owned banks lending money to state-owned enterprises and local governments at artificially low interest rates.

The result is lots of debt, which means that China's central bank can't pump up the economy anywhere close to the extent that it did in 2008 and 2015. China's share market fell 20% in 2018[10] — the good news is that this means there may now be plenty of good stock-picking opportunities in China. Nonetheless, we still believe that China's economy is going to remain lackluster. While the government has enough policy tools to stop it from crashing, we think that China isn't going to be a source of demand growth for the global economy.

2) Donald Trump is …. unpredictable.

Apart from Donald Trump's belief in tax cuts, the closest we have to a Trump policy doctrine is his maximum pressure negotiating stance. We saw this on display with his North Korean deal, and we are seeing it play out with the trade war with China.

The G20 summit in Argentina saw Trump and Chinese President Xi Jinping agree on a ceasefire, and there is the possibility that trade tensions will temporarily ease further in the next couple of months. But longer-term, we believe that President Trump will push even harder. In our view, he will probably continue with maximum pressure and announce more tariffs, potentially on the entire $550 billion worth of Chinese exports to the U.S. The biggest risk with the trade war isn't the economic impact — although this isn't exactly good, we see it as manageable. The bigger worry, in our view, is that this trade war leads to increased military tensions.

For example, the South China Sea is an area of hotly contested sovereignty. China claims most of it and has been building military bases on tiny reef islands. However, the U.S. does not recognise Chinese sovereignty over these islands, and the U.S. Navy has been conducting freedom to navigate operations since 2015. In October 2018, a Chinese ship deliberately maneuvered across the bow of a U.S. ship and forced it to take evasive action.[11] An actual collision would have been a significant military incident and possibly a risk-off event for markets.

In sum, tensions remain elevated, and this is why we aren't expecting either side to meaningfully back down.

1) 2020 - the U.S. recession danger zone.

By now, I'm sure you're sick of hearing people saying how late it is in the cycle. Of course, it could all be different this time around - we could be mid-way through a historic period of uninterrupted growth, but we don't think so.

In a nutshell, we still think it's very late in the cycle and while we can't be sure when it will end, we are pretty convinced it won't be 2019. Instead, we think that there are danger signals for the U.S. around 2020. Given that bear market markets don't usually start until around six months before a recession, we've probably got another year of okay, but volatile markets ahead of us.

Yet, it's important to recall the magnitude of the drop typically witnessed in down markets. Since World War II, the S&P 500® Index has experienced an average fall of 33% during bear markets.[12] And remember that it takes a 100% rebound to recover from a 50% fall. Therefore, it's perfectly possible that a burst of late cycle euphoria drives equity markets substantially higher over 2019, but longer-term, we worry that the downside outweighs the upside.

All in all, 2019 seems set to be another interesting year, following in the footsteps of 2018. Stay tuned as we monitor the latest developments.

[1] Source: https://www.cnbc.com/2018/12/20/the-year-nothing-worked-every-asset-class-is-in-the-red-in-2018.html [2] Source: Russell Investments, 2019. [3] Source: Russell Investments, 2019. [4] Source: Source: https://www.imf.org/external/datamapper/CG_DEBT_GDP@GDD/CHN/FRA/DEU/JPN/GBR/USA/ITA [5] Source: https://www.theglobeandmail.com/business/article-italys-political-crisis-jolts-markets-rattles-all-of-europe/ [6] Source: https://www.research.unicredit.eu/DocsKey/fxfistrategy_docs_2018_164967.ashx?EXT=pdf&KEY=KZGTuQCn4lsvclJnUgseVGkpNcRX WLoNFhsvJBXHbE69WfFEurg==& [7] Source: Bloomberg as at 15, January 2019. [8] Source: Russell Investments, 2019. [9] Source: https://tradingeconomics.com/italy/government-bond-yield [10] Source: MSCI China Index as at 15, January 2019. [11] Source: https://www.bloomberg.com/news/articles/2018-10-02/china-says-navy-drove-u-s-warship-from-south-china-sea-reef [12] Source: https://www.cbsnews.com/news/whats-a-bear-market-and-how-long-might-it-last/

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